McDermott
Will&Emery

Boston Brussels Chicago Düsseldorf London Los Angeles Miami Milan
Munich New York Orange County Rome San Diego Silicon Valley Washington D C

Gregory K Lawrence
Attorney at Law
glawrence@mwe com
617 535 4030

January 10, 2005

VIA HAND DELIVERY AND EMAIL

Mary Cottrell, Secretary
Department of Telecommunications and Energy
One South Station
Boston, Massachusetts 02110

Re: D.T.E. 04-115 - Comments of Morgan Stanley Capital Group Inc.

Dear Ms. Cottrell:

Enclosed please find an original and ten copies of Morgan Stanley Capital Group Inc.'s comments on the procurement of default services power supply for residential and small commercial and industrial customers. A copy of these comments has also been sent via email to dte.efiling@state.ma.us. Please call me at (617) 535-4000 if you have any questions.

Sincerely,

Gregory K. Lawrence
Terence T. Healey
Attorneys for
Morgan Stanley Capital Group Inc.

GKL/tam
Enclosure

COMMONWEALTH OF MASSACHUSETTS
DEPARTMENT OF TELECOMMUNICATIONS AND ENERGY

Request For Comments On The Procurement Of Default Service Power Supply For Residential And Small Commercial And Industrial Customers	))))	D.T.E. 04-115

COMMENTS OF MORGAN STANLEY CAPITAL GROUP INC.

I. INTRODUCTION

Morgan Stanley Capital Group Inc. ("MSCG") submits the following comments to the Department of Telecommunications and Energy (the "Department") in response to the Department's December 6, 2004 *Request for Comments on the Procurement of Default Service Power Supply for Residential and Small Commercial and Industrial Customers*. MSCG supports an open regulatory process to develop well designed, transparent practices for the statewide procurement of default service supply. MSCG appreciates the opportunity to provide its comments in this proceeding.

Massachusetts currently uses competitive solicitations through individual requests for proposals ("RFPs") by distribution companies and individually negotiated supply agreements to procure default service supply. In its requests for comments, the Department seeks input as to the advantages and disadvantages of using a statewide procurement process for default service load. For the reasons discussed below, the procurement of default service for residential and small commercial and industrial customers should be accomplished through a competitive,

wholesale, statewide auction process similar to the basic generation service ("BGS") auction that has been implemented with substantial success in New Jersey.[1]

New Jersey's BGS statewide auction process is a vertical, full requirements, multi-round, descending clock, on-line auction in which qualified bidders submit offers to supply "tranches" of load for a designated period pursuant to a standardized "Supplier Master Agreement." The BGS auction process consists of two auctions that are held concurrently, one for larger customers on an hourly price plan ("BGS-CIEP") and one for smaller commercial and residential customers on a fixed-price plan ("BGS-FP"). As the auction progresses, prices decrease until the bids account for the total amount of load in the auction. In the BGS auction design, price is the only variable since all other terms and conditions of service are defined in the Master Supply Agreement, which is approved by the New Jersey Board of Public Utilities well in advance of the auction.

The New Jersey BGS auction is a well designed process first implemented in 2002 and that has resulted in successful auctions. Some of the key characteristics of the BGS auction that add to its success - all of which attract a greater number of qualified bidders - are:

- Open and transparent process open to all market participants used to develop a single set of supply agreements, credit requirements, auction rules, and bidder qualifications, resulting in supply contracts that work and are accepted by the industry.

- Power supply master agreements and auction structure pre-approved by the utility commission. This promotes efficiency and certainty. Under this structure, competition is based on price, and not on the success or failure of a bi-lateral contract negotiation.

- Independent auction administrator.

[1] The New Jersey BGS auction procurement process has been heralded as "one of the great successes of deregulation." See Power Markets Week, *16 Win Bids to Supply N.J For 5.2-Billion After Utility Auction Stirs PJM Market.*, (February 10, 2003).

- Statewide solicitation whereby all utilities use the same auction structure, documents and process. This is efficient, transparent and attracts bidders.

- Staggered solicitations with varying contract terms, leading to prices that reflect market forces.

- Efficient 2-day review and approval by the utility commission of the results of the auction such that bidders are not required to hold open hedged positions for an unnecessary amount of time. This reduces the potential that a risk premium will be added to bids to cover hedges and open positions.

The Department should consider establishing a working group to discuss a potential timeline for the implementation of a statewide procurement process in Massachusetts for default service.

II. COMMENTS

In its request for comments, the Department asked parties to submit responses to five specific questions. MSCG addresses each question below. MSCG's responses to these questions form the general outline of a proposal for the procurement of default service in Massachusetts going forward.

1. Would smaller customers be better serviced if power supply for default service is procured using a portfolio of more than two solicitations? Please discuss the advantages and disadvantages of increasing the number of solicitations used to procure default service supply.

The number of solicitations is less important than the actual design of the solicitation process in terms of the size of the load offered and at what frequency solicitations are held. MSCG supports a staggered approach similar to that used in the New Jersey BGS auction process for the statewide procurement of default service, namely, a "laddered approach" to procuring a portfolio of several shorter and longer term contracts for overlapping terms. With that said, MSCG supports the use of annual solicitations.

Conducting solicitations more frequently than once a year may result in market fatigue, or a "dulling" of the individual solicitations. Suppliers and the utilities will be required to

expend significant resources without corresponding gains in efficiency or price. The New Jersey, Maryland and District of Columbia procurement processes conduct annual statewide solicitations. The annual statewide solicitation approach attracts a significant amount of attention from the field of potential suppliers. If solicitations were held more than once a year, suppliers may come to the conclusion that they potentially have another "bite at the apple" through a second solicitation, thereby reducing the incentive to participate in the initial solicitation. In such a scenario participation by the potential suppliers may be reduced. An annual solicitation procuring a portfolio of several shorter and longer term contracts for overlapping terms would effectively address the Department's goal that the procurement results reflect market conditions. This approach is superior to multiple solicitations, such as the concept of implementing eight quarterly solicitations, noted in the Department's Request for Comments.[2]

2. Would smaller customers be better served if power supply for default service was procured for a term longer than twelve months? Please discuss the advantages and disadvantages of using supply terms greater than twelve months. In particular, please discuss:

a. whether longer contract terms are likely to produce lower prices

Longer-term contracts of three to five years would mitigate the impact of market fluctuations and help attract more bidders. Suppliers are generally more willing to devote resources to longer contracts of three to five years. Longer contract terms are financially more valuable to suppliers and allow suppliers to hedge more effectively. Longer contract terms of three to five years also would help to mitigate the price volatility associated with shorter contracts. A three to five year term would likely create the potential for lower prices (as compared to the then-current market), added market flexibility, and a procurement process that is less vulnerable to market conditions and risk. Greater participation by qualified bidders

[2] Request for Comments at 4.

ultimately leads to greater market liquidity and, with such liquidity, the likelihood of lower wholesale bids and prices for retail consumers. New Jersey's BGS auction structure, including three year contract terms, has led to high participation levels by qualified bidders, with participation increasing significantly in each of the three auctions that have taken place. A fourth auction has been approved to take place in February, 2005. In its request for comments, the Department noted that lengthening the procurement term might weaken the connection to market prices.[3] Staggered procurement contracts of three to five years would address the Department's concerns of balancing price certainty and market efficiency since market changes would still be reflected through a "term-averaging" of the staggered contracts.

b. how such an approach would affect price certainty and market efficiency

A statewide auction with an annual procurement for staggered terms of three to five years, documented in supply agreements approved by the Department before the auction takes place, would result in greater price transparency, and thus, greater market efficiency. Currently there is little or no transparency in the RFP default service procurement process. Utilities and a potential supplier essentially negotiate contract terms on a bi-lateral basis. As a result, many participants choose not to offer supply, and consequently, competition decreases. A dynamic, well-designed, on-line auction that implements a standardized and objective approach for potential bidders, would create greater transparency and encourage increased participation, and the likelihood of the lowest-cost, market-based wholesale supply contracts and, default service prices for consumers.

[3] Request for Comments at 3.

c. how such an approach could be tailored to accommodate customer migration to competitive supply

It is crucial to properly segment the customer base and load to be offered individually in the auction. Larger customers -- *e.g.*, large commercial and industrial customers -- are more likely to migrate to competitive retail service and should be included in one class, and smaller commercial and residential customers in another class. Suppliers may add a risk premium to bids to address the greater likelihood of large customer migration. If the design of the procurement process does not segment the customer base correctly, smaller customers will unnecessarily bear increased risk premiums created by the need to account for migration by larger customers. The manner in which the customer base is segmented also would need to be known up-front by those bidders participating in the procurement process, and remain consistent throughout the supply contract term.

3. Would smaller customers be better served if power supply for default service was procured on a statewide basis? Please discuss the advantages and disadvantages of using a statewide approach to default service procurement.

Smaller customers would be best served by a statewide procurement process for default service. A statewide procurement process with standardized wholesale contract terms would lower the cost for suppliers to pursue a particular customer base under a single wholesale contract. The use of a declining clock auction model with a standard contract for the procurement of BGS on a statewide basis has been highly effective in New Jersey. The number of participating suppliers has increased each year the BGS auction has been offered. Currently, in Massachusetts, many suppliers likely choose not respond to the RFPs of individual distribution companies due to the multiple, varied contracts and individual costs associated with pursuing those individual RFPs and negotiating individual contracts. A more transparent, statewide process with a standard contract and the opportunity for increased load, would lead to greater participation by qualified bidders.

4. **Would smaller customers be better served if power supply for default service was procured using an auction process (e.g., descending clock) rather than through requests for proposals? Please discuss the advantages and disadvantages of using an auction process to procure default service. In particular, please discuss whether using an auction is likely to produce lower default service prices.**

A vertical, full requirements, declining clock auction, such as the one conducted in the New Jersey BGS is, by design, a highly open and competitive process that produces transparent clearing prices. This auction process results in a fair, market-based price for fixed price residential and small commercial customers. A well-designed auction with transparent bidding and evaluation rules will encourage participation by qualified bidders and thus, foster increased competition and the likelihood of the lowest possible prices for default service. Bidding is head to head in such an auction. This auction structure also properly allocates risk to those who can manage that risk at the lowest cost and therefore encourages more aggressive bidding. A transparent auction with fair rules also minimizes post-auction challenges to the auction results.

For example, the New Jersey BGS auction process benefits from being both objective and highly standardized (*e.g.*, all terms and conditions of service are defined in the Master Supply Agreement). This ensures that competition will be on a price basis and that price is the only significant variable. As a result, the auction is transparent. This increases the level of confidence in the validity of the auction results. In addition, the bulk of regulatory oversight is conducted at the outset, thereby reducing the regulatory uncertainty amongst suppliers and customers that is generally associated with an after-the-fact regulatory review of contract terms and the procurement process. Reducing contract uncertainty and risk for qualified bidders will likely result in lower wholesale prices because suppliers will not need to add risk premiums to bids to hedge these uncertainties.

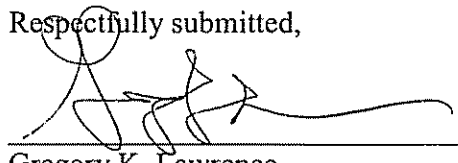
5. **Although the term "default service" is statutory, G.L. c. 164, § 1, it has confused some customers because of its unintended suggestion of nonfeasance in performing a legal or contractual obligation. Is there some better or more descriptive term that ought to be used by the distribution companies on and after March 2005?**

In place of "default service," MSCG offers the following terms for consideration: Basic Generation Service, Basic Energy Service, and Standard Energy Service.

III. CONCLUSION

MSCG appreciates the opportunity to submit comments on the procurement of default service power supply for residential and small commercial and industrial customers, and looks forward to continued participation in this proceeding. MSCG urges the Department to consider the implementation of a statewide default service procurement process similar to that currently in place in New Jersey.

Respectfully submitted,



Gregory K. Lawrence
Terence T. Healey
McDermott, Will & Emery LLP
28 State Street
Boston, Massachusetts 02110-1775
Phone: 617.535.4000
Fax: 617.535.3800
Email: glawrence@mwe.com
thealey@mwe.com

Attorneys for
Morgan Stanley Capital Group Inc.

Dated: January 10, 2005